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IN THE

Supreme Court of the United States

OCTOBER TERM, 1986

DAVID CARPENTER, KENNETH P. FELIS, and R. FOSTER WINANS,

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF FOR PETITIONERS

JED S. RAKOFF
HOWARD W. GOLDSTEIN
JAMES NISS
MUDGE ROSE GUTHRIE
ALEXANDER & FERDON
180 Maiden Lane
New York, N.Y. 10038
(212) 510-7000
Counsel for Petitioner
David Carpenter

E. MICHAEL BRADLEY
I. SCOTT BIELER
BROWN & WOOD
One World Trade Center
New York, N.Y. 10048
(212) 839-5300
Counsel for Petitioner
Kenneth P. Felis

DON D. BUCHWALD
BUCHWALD & KAUFMAN
600 Third Avenue
New York, N.Y. 10016
(212) 661-0040
Counsel for Petitioner
R. Foster Winans

PPP

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Petitioners David Carpenter, Kenneth P. Felis and R. Foster Winans respectfully submit this reply to the Government's brief in opposition to our petition for a writ of certiorari.

ARGUMENT

I.

Review By This Court of the Judicially Created "Misappropriation Theory" of Criminal Liability Under SEC Rule 10b-5 Is Timely and Warranted

This case presents the issue of whether SEC Rule 10b-5 imposes criminal sanctions on a newspaper columnist for "misappropriating" his newspaper's publication schedule as part of a scheme to trade certain securities, even though his newspaper — the only alleged victim of securities fraud — has no interest in the securities traded. Apart from the special concerns raised by criminalizing certain professional conduct of a newspaper columnist,[1] the case squarely presents the broader issue of whether an alleged "fraud" against a person or entity having no interest in securities can constitute a criminal violation of laws chiefly intended to protect such interests.

As its primary response to our petition, the Government argues that review by this Court is "premature" because only one circuit court of appeals has considered or adopted the "misappropriation theory" of criminal liability under Rule 10b-5. Gov't Br. at 7-8. This argument is unpersuasive. Six years ago, arguing for affirmance of the Second Circuit's decision in *United States v. Chiarella*, 588 F.2d 1358 (2d Cir. 1978), *rev'd*, 445 U.S. 222 (1980), the Government itself urged this Court to adopt the "misappropriation theory." *Chiarella v. United States*, 445 U.S. 222, 235 (1980). The Court declined because the

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1. *See* Brief of the Reporters' Committee for Freedom of the Press, *et al.*, as Amici Curiae in Support of Petitioners ("Br. Reporters' Comm.").

misappropriation theory was not properly presented by the *Chiarella* record, 445 U.S. at 236–37, and left "the resolution of th[e] issue for another day." *Id.* at 238 (Stevens, J., concurring). In the six years since *Chiarella*, the Second Circuit not only adopted the misappropriation theory,[2] but, in this case, expanded it beyond anything contemplated by *Chiarella* so as to cover alleged injury to a financial newspaper's reputation despite the total absence of fraud against any securities investor. We do not challenge this Court's frequent practice of allowing new questions of law to "percolate" in the courts below before review here; but we submit that six years has provided sufficient percolation for an important issue expressly reserved by the Court — important not only for the development of the law but also for the growing number of defendants who have gone to prison pursuant to this unreviewed judicial gloss of an agency–created rule.

It is hardly surprising that consideration of the misappropriation theory has been confined to the Second Circuit. The theory is not available in private civil actions.[3] In criminal actions, the Justice Department has a long–standing practice of bringing insider–trading securities cases in the Southern District of New York — the only district where the United States Attorney's Office has a specialized unit for securities fraud.[4] SEC civil enforcement actions under the misappropriation theory[5] have likewise been largely centered in the

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2. *See, e.g., United States v. Newman*, 664 F.2d 12 (2d Cir. 1981), *aff'd after remand*, 722 F.2d 729 (2d Cir.), *cert. denied*, 464 U.S. 863 (1983).

3. *Moss v. Morgan Stanley Inc.*, 719 F.2d 5, 16 (2d Cir. 1983), *cert. denied sub nom. Moss v. Newman*, 465 U.S. 1025 (1984).

4. Our informal survey indicates that, of the more than 50 criminal securities prosecutions thus far brought for trading on inside information, all but one was brought in the Southern District of New York, and that one was disposed of by a guilty plea.

5. *E.g., SEC v. Materia*, 745 F.2d 197 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985).

Southern District of New York, not only because of its role as the hub of financial activity but also because, inasmuch as most principal national stock exchanges are located in the Southern District of New York, jurisdiction based on "use of any facility of any national securities exchange," 15 U.S.C. § 78j(b), most naturally lies in that district for virtually all 10b–5 actions involving publicly traded securities.

Now that the Second Circuit has accepted the misappropriation theory, the Government is clearly in a position to keep *all* actions (i.e., criminal prosecutions and civil enforcement actions) based on that theory within the confines of the Second Circuit, and indeed would have a strong incentive to do so if some one–circuit rule could immunize the theory from review by this Court. Fortunately, there is no such immunity. As *Chiarella* itself demonstrates, this Court has never hesitated to review (and reverse) the Second Circuit's decisions, regardless of the fact that, as is usually the case in this area, the issues have not been considered by any other circuit.

Review is timely for other reasons as well. The decision of the Second Circuit majority has far–reaching implications for individuals who are subjected to novel criminal prosecutions, as well as for the operation of this nation's securities markets and the workings of the press. *See* Brief Amicus Curiae in Support of the Petition for a Writ of Certiorari filed by the Securities Industry Association, Inc. and Br. Reporters' Comm. One needs only to open any newspaper to understand the importance of clear rules on criminal liability in insider–trading cases.[6] With additional

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6. Williams, "What's Legal — And What's Not," Fortune, Dec. 22, 1986, at 36–37 ("The SEC has a manhunt on for inside traders. But the rules are so vague that its hard for arbitragers — and managers — to know if and when they have sinned."); Editorial, "SEC v. ?", *Wall Street Journal*, Nov. 20, 1986, at 34, col. 1 ("The problem with the SEC is that the crime it presumably is pursuing, 'insider trading', has for some time now

prosecutions looming on the horizon, a ruling by this Court on the scope of these federal securities laws is necessary to alleviate the widespread confusion that now exists. No financial issue today is more topical or important.

In its second argument, the Government, having first argued that review is "premature" and that the issues here are of first impression, reverses its field and argues that review is inappropriate because this case involves shopworn principles of insider trading. Gov't Br. at 8–11. Relying upon piecemeal citations to the extremely broad language of section 10(b) and Rule 10b–5,[7] the Government wholly disregards the limitations placed by this Court on liability under these provisions. In *Chiarella*, and again in *Dirks v. SEC*,[7] this Court held there can be no violation of Rule 10b–5 unless there is some relationship between the shareholders of a company affected by securities transactions and the defendants accused of trading on material non–public information. When this Court in *Chiarella* contemplated (without deciding) the misappropriation theory, it did so within these parameters. *See* 445 U.S. at 233. As the dissent below made clear, this crucial limitation was not respected by the Second Circuit majority, and presumably will not be respected in future prosecutions under the theory of this case. More generally, the opinion below recognized that it represented an important decision of "first impression." *United States v. Carpenter*, 791 F.2d 1024, 1027 (2d Cir. 1986), Appendix to Petition for Writ of Certiorari at 8a.

Not only is the decision below unprecedented and unwarranted, it actually flies in the face of this Court's decisions in *Chiarella* and *Dirks* by silently accepting

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lacked clear definition. No wonder the markets are uncertain ... see[ing] cases trying to further stretch the definition of 'insider' trading, ... since such an expansion could reduce, rather than expand, the amount of information available to the market.").

7. 463 U.S. 646 (1983).

rationales expressly rejected in those cases. Thus, although the Government denies that this case is a return to the previously rejected parity-of-information rule, its position dictates just that result. The Government argues that petitioners "fraudulently misappropriated information that was not lawfully available to the other parties to the transactions" (Gov't Br. at 13), totally ignoring the fact that information upon which the trades were made was not taken in breach of any duty owed to these parties or indeed to any market participant. Petitioners owed absolutely no duty to these purchasers. The decision below is thus clearly contrary to the holdings of this Court on the necessity of a duty and injury cognizable under the securities laws to support liability under the securities laws.[8]

In short, review by this Court is not only timely and appropriate, it is utterly necessary if the force of this Court's prior decisions in this area is to be respected.

II.

The Lower Court's Unbridled Expansion of The Mail and Wire Fraud Statutes Warrants Review and Reversal

The Government's characterization of petitioners' mail and wire fraud convictions as an "unexceptional application of settled law" fails fairly to acknowledge the growing stream of criticism among courts and

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8. As for the Government's claim that there is nothing anomalous about an insider-trading rule that applies to an employee but not to the employer, the short answer is that Rule 10b-5 allows no such distinction. It applies only to breaches of fiduciary duties cognizable under the federal securities laws, and then to such breaches by employer and employee alike. Winans' breach of his duty to his employer, which was not a market participant and which itself created the duty breached through its unilateral proclamation of an internal policy designed to protect its reputation, is simply an insufficient predicate for petitioners' convictions.

scholars over the unbridled judicial expansion of these statutes. With every such expansion, more and more judges, dissenters though they be, have levelled ever more urgent warnings against such expansion. *See* Petition for Writ of Certiorari at 23–24 nn.55–57.

This case, representing the most extreme application of this expansion to date, is thus an appropriate vehicle for review of this expansion by this Court, which has never before reviewed it. The Government, like the Second Circuit, points to no "fraud" in this case, but only to Winans' failure to disclose to his newspaper that he had breached its private workrules by disclosing its publication schedule. This expansion of the concept of "fraud" to include all breaches of a privately-defined fiduciary duty by an employee requires reversal. The mail and wire fraud statutes should not be construed to federalize the ordinary relationship between employer and employee. The potential criminalization not only of all private workrules, but of every breach of a fiduciary obligation, constitutes an abusive distortion of the intended purposes of these federal statutes. *See United States v. Siegel*, 717 F.2d 9, 24 (2d Cir. 1983) (Winter, J., dissenting).

The Government also mischaracterizes petitioners' argument based upon the requirement of the statutes that the mailing or wiring be made "for the purpose of executing" a fraudulent scheme. Of course, petitioners never said the statutes require that "the defendant personally deposit an item in the mailbox or place a call on a telephone." Gov't Br. at 16–17. Instead, it is the decision below that has done violence to the terms of the statute by effectively eliminating the requirements of both causation and purpose. The cases cited by the Government are inapposite, involving situations in which the mailings and wirings were somehow part of a fraudulent scheme and would not have occurred in the same form or with the same content without the fraud. *Pereira v. United States*, 347 U.S. 1 (1954) (completion of a confidence fraud

requiring mailing of a check to drawee bank that would not have occurred but for the fraud); *United States v. Muni*, 668 F.2d 87, 90 (2d Cir. 1981) (completion of credit card fraud to give "appearance of legitimacy" by causing wirings by a merchandiser, as part of authorization process, that would not have occurred but for the fraud); *United States v. Castor*, 558 F.2d 379, 386 (7th Cir. 1977) (execution of liquor permit fraud furthered by mailings would not have occurred but for the fraud), *cert. denied*, 434 U.S. 1010 (1978).

In this case, the so-called "fraud" — Winans' unauthorized disclosure of his employer's publication schedule — was entirely completed before any of the predicate mailings or wirings took place. Moreover, neither the timing nor content of any of the mailings or wirings was affected by any aspect of the scheme — the articles appeared in the *Wall Street Journal* exactly as they would have without Winans' unauthorized use of his employer's publication schedule. By permitting convictions of mail and wire fraud to be based on such tenuous predicates, the lower court has removed all bounds to federal criminal jurisdiction under the statutes. This alone warrants review and reversal in this case.

CONCLUSION

For the reasons set forth above, petitioners respectfully request that this Court issue a writ of certiorari to review the judgments of the Court of Appeals for the Second Circuit.

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Respectfully submitted,

Jed S. Rakoff*
Howard W. Goldstein
James Niss
Mudge Rose Guthrie
Alexander & Ferdon
180 Maiden Lane
New York, New York 10038
(212) 510-7000
Counsel for Petitioner
David Carpenter

E. Michael Bradley
I. Scott Bieler
Brown & Wood
One World Trade Center
New York, New York 10048
(212) 839-5300
Counsel for Petitioner
Kenneth P. Felis

Don D. Buchwald
Buchwald & Kaufman
600 Third Avenue
New York, New York 10016
(212) 661-0040
Counsel for Petitioner
R. Foster Winans

* Counsel of Record